

Part 2
BRINGING HOME THE INVESTMENT:
*What Does It Take To Make Internal
Investment Management Work?*

June 15, 2015

by

Rick Funston, Lance Ihinger, Randy Miller, Keith Bozarth
and Keith Johnson



Introduction

This article, the second of a two-part series, addresses how systems can improve their understanding of what it takes to successfully increase internal investment management including a cost/benefit analysis (both qualitative and quantitative) and the “opportunity cost” of in-house vs. external management, anticipating legal and regulatory challenges, determining which mid- and back-office functions to insource, estimating the capital requirements for improved infrastructure, developing the right investment philosophy and culture, and aligning governance required to support successful implementation.

Cost / Benefits

Evaluating the qualitative costs and benefits of this type of decision are at least as important as the quantitative factors but, by their nature, are more difficult to assess. There are several qualitative factors that are important to consider, including:

- The degree of independence afforded the system to react to both rapidly changing market conditions as well as longer-term investment mandates
- The ability to attract and retain highly qualified staff
- The ability of the organization to effectively manage the surge in new information systems and/or outsourcing relationships
- The ability to manage any changes that might occur in the relationship with the board
- The ability to effectively implement the necessary policies, controls and oversight structure

The key to evaluating the qualitative factors is to identify the advantages and disadvantages of moving to the new investment model versus the status quo and obstacles to their achievement.

Qualitative advantages of increased internal investment include: depth of in-house investment expertise; improved control, responsiveness and visibility; improved ability to align goals and accountability; and, competition for outside managers.

Depending on your perspective, some of the disadvantages might include, for example: staff become more directly accountable in the event of poor performance (even though the fiduciaries are ultimately responsible); the system becomes more reliant on key employees and thus the need for increased focus on retention; increased reliance on internal systems, including the greater importance of business continuity and disaster recovery; and, risk management, compliance and controls become more critical to prevent, detect and correct rogue trading.

Systems also need to evaluate the “opportunity cost” associated with an in-sourced structure vs. an outsourced structure, i.e., potential under-performance. Under-performance should be addressed with a focus on all the same factors as are applied to external management. We have typically seen public funds report and evaluate internally managed asset class performance the same way they report and evaluate externally managed asset class performance.

In some cases, an asset class is mixed with some internal and some externally managed portfolios. Each portfolio is managed against its benchmarks and performance is assessed accordingly. If there is a sustained period of under-performance, managers are put on the “watch list” and may be formally evaluated for termination. This same approach can apply to internal management.

Once internal management is established, ongoing evaluation requires a combination of the disciplines used to monitor external managers with classic personnel management. The same array of factors used to hire and monitor an external manager is applicable to internal portfolios. While qualified, skilled personnel are the foundation, the systems, investment philosophy, replicability and "bench strength" are also important. All of the same factors should be assessed in an ongoing evaluation of internal management.

Performance numbers alone are not a sound basis for evaluation internally, any more than externally. A difficult challenge is determining how and who should conduct that ongoing evaluation. A third party evaluator may be a reasonable option, even though each system already likely has a team (including a consultant) dedicated to performing that same task on external managers.

The ultimate correction for an external manager who no longer meets the grade is termination. However, a system is less likely to terminate an internal portfolio management team. Turning the decision into a personnel issue is not necessarily the proper answer either; hence, the possible merit of an external assist in evaluation. Using one staff team to evaluate another staff team is problematic. There are also pros and cons of using the same consultant to evaluate both external and internal portfolios. Regardless of the mechanism used, however, a comprehensive approach that includes both system and personnel concerns is needed and should be carefully designed in advance.

The other side of having both internal and external management is that the fund may be able to strengthen both through the synergies. The perspective brought by internal portfolio managers and analysts can help add to the evaluation of external managers. A staff/consultant team dedicated to manager selection and oversight should still lead the process, but the internal portfolio teams can add insights. Likewise, insights gained from external managers can help internal portfolio management improve.

It is not possible to accurately determine prospectively an “opportunity cost” for internal management vis-à-vis external managers. If a public fund cannot be confident that its internal investment managers can achieve their benchmark target performance with the same level of confidence they have in external managers, then the fund has probably not done an effective job of recruiting and building its internal staff.

There are also costs and challenges associated with retaining an experienced and talented investment staff necessary to execute an internal investment management program. How do you design a compensation structure that attracts and retains the right people? How do you evaluate the geographic challenges associated with retaining key investment professionals?

Each system should develop the assumed compensation structure and program that would be used to build the business case for internal investment management. This would include assumptions about base salaries and bonus/incentive programs. Key inputs include past compensation studies and the experience of other systems in recruiting, developing, compensating, and retaining investment staff. The system should also anticipate the need to adopt a process for regular independent compensation studies as critical to structuring and supporting a compensation program that will attract and keep qualified staff.

To estimate the anticipated costs of internal management, for each asset class being considered, the first step is to determine the requirements in terms of the number of staff and their level of experience. CEM has found “On average, those funds that have internal management employ one front office full time employee (FTE) for every £0.5 billion (US\$750 million) in public equity.” John Simmonds, principal at CEM states “We worked on the hypothesis that, getting started, you would want at least three front office FTE to mitigate some of the key-man risks. For every front office FTE, CEM’s data reveals that funds need a further two in the back office. That makes a minimum of nine FTEs – three in the front office and six in the back office.”¹ This estimate should also consider the assumed strategies within the asset class, including active vs. passive strategies, domestic vs. international, use of derivatives, etc.

When these assumptions have been developed, the assumed level of compensation required for each position can be determined, as well as recruitment cost, and the total staff costs can be estimated. CEM also found that “the global average all in cost, including all overheads, of each full time employee is £250,000 (about US \$387,000). That equates to a total budget of approximately £2.25 million (US\$3.5 million) to get started.”²

Finally, the system should avail itself of quantitative benchmarking to compare peer funds’ headcount supporting each asset class utilizing internal management. For each internal

¹ What is the minimum AUM for internal management? Amanda White, www.top1000funds.com May 20, 2015

² Ibid.

investment scenario considered, there should be a projection of headcount required based upon peer funds with similar strategies and number of mandates in each asset class.

There may also be legal and regulatory challenges. Identifying and addressing regulatory and legal challenges should include:

- Benchmarking against staffing, policies and practices in place at other public funds with internal management, covering things such as SEC reports on direct holdings, insider trading restrictions, foreign holdings reports, derivatives trading compliance, and foreign tax reclaims
- Ensuring that legal staff includes expertise on investment management and compliance functions (and has access to outside counsel expertise as required)
- Evaluating whether some functions can be delegated to the global custodian and investment advisors
- Recognizing that public pension funds are exempt from many of the regulatory requirements that apply to private investment managers (e.g., exempt from the Investment Advisor Act, tax exempt under s. 115 of the Internal Revenue Code), these added tasks are not too burdensome.

Systems also need to determine whether certain middle- or back-office functions should remain outsourced. The consideration of outsourcing starts with the Business Services Architecture which is a prerequisite for the business application architecture and any vendor / provider selection process. The business operating model requirements must drive the platform and data management solution strategy. The system should determine which business components should be expected to support standardized processes (and thus a potential candidate for outsourcing) vs. unique / specialized processes.

It is also important to gain insight into how asset management peers are handling similar needs and addressing common issues in conjunction with knowledge gained from benchmarking. Benchmarking should highlight any noteworthy perspective on the investment management practices relative to leading industry and peer firm practices, lessons learned and pitfalls to avoid.

Systems will also need to determine the capital, information system and human requirements associated with internalizing each asset class independently. The first step in estimating capital requirements associated with internalizing asset management is to develop the investing assumptions for each asset class (active vs. passive, domestic vs. international, use of derivatives, etc.). Based upon these assumptions, a system can identify the types of experience necessary and, more importantly, the types of infrastructure and controls necessary to support the required transactions.

In addition to the staffing and investment estimates, quantitative benchmark data can be used to identify staffing levels at other leading public pension funds in each asset class with similar types of investing strategies. This should help to ensure that the estimates the team develops are consistent with what other funds experience.

We believe some of the important elements of a successful investment office include having the right investment philosophy and culture. Important examples are: clearly defined roles and responsibilities with a high degree of accountability; a focus on goals and performance; risk awareness and risk intelligence in day-to-day activities and decision-making; an emphasis on cost effectiveness and value for money; the effective sharing of ideas, openness, and frequent communications across the organization; and continuous education / training.

A shift in focus on goals and performance associated with increased internal management will likely change human resources strategies and policies, within the constraints of the existing statutes. Along with an emphasis on performance, the system will need to emphasize an accountable culture, intelligent risk taking and cost effective and prudent investment management. The compensation structure will likely be different and may require both initial support from a compensation consultant and then periodic updates.

Having good ethics, conflicts, compliance, self-evaluation, audit, risk management and reporting policies and practices in place from the start can support a healthy culture and help to resolve issues more quickly with less damage when they do arise.

We believe establishing a continuing education and training program is effective in defining and contributing to a successful culture. Not only does this program improve skills, this set-up will also change culture in a positive way when continuous education is expected and accepted throughout the organization. Continuing education and training also helps attract intellectually curious investment personnel.

In the fiduciary reviews that we have conducted of investment operations, governance structure has been a major area of focus. For example, an effectively functioning staff investment committee is an evolving leading practice at a growing number of leading public pension funds.

It is important that responsibility, authority and competency for each type of decision be properly aligned. All decisions delegated to the Executive Director, CIO and each staff member should be assessed to ensure that this alignment is appropriate. In addition, ongoing training/ education, external audit, regular 360° and self-evaluation processes, performance attribution, compliance, risk management, independent fiduciary reviews and stakeholder reporting requirements are all part of an effective oversight program.

A feasibility study should conclude with recommendations about whether the transition to increased internal investment management is practical. If so, it should provide an internal asset management recommendation regarding asset class strategies, projected costs and benefits, key risk mitigation strategies and a roadmap to achieve the recommended course of action.

The roadmap should describe the key implementation steps, required capabilities and staffing, systems and infrastructure and governance policies and procedures. The roadmap should also describe dependencies and critical success factors with timelines and options for pacing the rollout.

Conclusion

Increasing internal investment is feasible under the right conditions. Systems need to have the right scale, the necessary authority, the willingness to compensate competitively and confidence in the ability of the organization to successfully make the transition. Key stakeholders also need to have a common understanding, acceptance and commitment to the transformation. Without their confidence and support, success will be at risk.

Thorough analysis and planning are essential to success including establishing appropriate investment philosophy, culture and accountabilities, risk management, compliance and control systems, a performance focused organization and a practical transition plan. For those systems which choose to make the transition to internal investment management, the rewards can be well worth the effort and produce significant returns for the system and its beneficiaries.

About the authors

Rick Funston is the Managing Partner of Funston Advisory Services LLC which specializes in governance, operations and risk intelligence for public retirement systems.

Lance Ihinger is a principal with Cutter Associates LLC which specializes in serving the operational and technology needs of the global asset management industry.

Randy Miller is a principal with Funston Advisory Services LLC.

Keith Bozarth is the former Executive Director of the State of Wisconsin Investment Board (SWIB).

Keith Johnson leads the Institutional Investor Legal Services team from Reinhart Boerner Van Deuren s.c. (Reinhart Law).

For further information, contact

Rick Funston
Managing Partner
Funston Advisory Services LLC
rfunston@funstonadv.com